

DCAA MEMORANDUM FOR REGIONAL DIRECTORS COVER SHEET			
AUDIT GUIDANCE/AUDIT MANAGEMENT GUIDANCE MEMORANDUM NO.		06-PAC-009(R)	
March 31, 2006			
Date of MRD:			
Subject of MRD:	Audit Guidance on the Allowability of Shareholder State Income Taxes Assessed on Pass-Through Income of Subchapter S Corporations		
Current Audit Guidance and/or Audit Management Guidance Affected:			
CAM			
Paragraph 7-1402	Explanation of Effect on Current Version of CAM CAM will be updated to specifically state that all individual shareholder income taxes which are based on pass-through income of the contractor are unallowable on Government contracts.		
AUDIT PROGRAMS			
5 Digit Activity Code	Subactivity/Document Name	Step No.	Explanation of Effect on Current Audit Program
10100			This MRD results in no audit program changes; however, auditors should consider this guidance as appropriate when performing audits under the subject 5 digit codes
21000			
23000			
27000			
28000			
SHELL AUDIT REPORTS			
5 Digit Activity Code	Subactivity/Document Name	Sec./ Par.	Explanation of Effect on Current Audit Report
NONE			
MEMORANDUMS FOR REGIONAL DIRECTORS			
MRD No.	Date	Subject/Explanation of Change	
NONE			
INTERNAL CONTROL QUESTIONNAIRE/INTERNAL CONTROL MATRIX/INTERNAL CONTROL AUDIT PLANNING SUMMARY			
ICQ/ICM/ ICAPS	Section & No.	State Control(s) Affected by the Change	
NONE			
DCAA PAMPHLETS/REGULATIONS/INSTRUCTIONS			
DCAAP/R/I/No.	Date	Page/Sec./Par.	Explanation of Effect
NONE			
DMIS USER GUIDE			
Explanation of Effect			
NONE			



DEFENSE CONTRACT AUDIT AGENCY
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IN REPLY REFER TO

PAC 730.3.B.01/2006-07

March 31, 2006
06-PAC-009(R)

MEMORANDUM FOR REGIONAL DIRECTORS, DCAA
DIRECTOR, FIELD DETACHMENT, DCAA

SUBJECT: Audit Guidance on the Allowability of Shareholder State Income Taxes Assessed on Pass-Through Income of Subchapter S Corporations

Summary

On February 6, 2006, the U.S. Court of Appeals for the Federal Circuit (*Information Systems and Networks Corporation v. United States*, CAFC Nos. 04-5151, -5154) upheld the Government's longstanding position that individual shareholder state income taxes claimed by Subchapter S corporation contractors on their pass-through income are unallowable. Shareholder income taxes are not an expense of the contractor and are, therefore, unallowable under FAR 31.205-41, *Taxes*. Auditors should continue to question claimed costs for individual shareholder income taxes assessed on contractor pass-through income.

Background (S Corporations vs. C Corporations)

Election of the S corporation status is a decision made by the corporation and its limited number of shareholders (no more than 75 shareholders). The intended purpose of Subchapter S corporations is to provide tax benefits to individuals who decide to incorporate their business endeavors rather than to operate as proprietorships. The design and purpose is to have these individuals escape double taxation on the net income from the business. S corporations typically do not pay state income taxes. Rather, all of the S corporation's income, loss, deduction, or credit will pass through to the shareholders for inclusion in their personal income tax returns. Thus, election of the S corporation status inherently offers a tax advantage over C corporations. In most states, no tax liability is assessed against S corporations' earnings, whereas C corporations' earnings are subject to taxation at two levels. The earnings of C corporations are taxed directly to the corporations and any portions of those earnings passed on to the shareholders are also taxed on the shareholders' personal income tax returns.

Court Decisions

On February 6, 2006, the Court of Appeals reversed the decision by the Court of Federal Claims (*Information Sys. & Networks Corp. v. United States*, 48 Fed. Cl. 265, 2000 U.S. Claims) and stated that the lower Court had misinterpreted FAR 31.205-41. The Court of Appeals agreed with the Government that taxes which are not a liability of the contractor are unallowable on Government contracts.

SUBJECT: Audit Guidance on the Allowability of Shareholder State Income Taxes Assessed on Pass-Through Income of Subchapter S Corporations

The Court continued by stating that the lower Court failed to recognize that the cost principles apply only to the costs of the contracting entity. Since the contractor is an S corporation, the contractor is not assessed and therefore not liable for State income taxes. Therefore, the subject taxes are unallowable costs to the contractor under FAR 31.205-41, which states in pertinent part:

FAR 31.205-41, Taxes

(a) The following types of costs are allowable:

(1) Federal, State, and local taxes (see Part 29), except as otherwise provided in paragraph (b) of this section that are required to be and are paid or accrued in accordance with generally accepted accounting principles (emphasis added).

Concluding Remarks

If FAO personnel have any questions, they should contact regional personnel. If regional personnel have any questions, they should contact the Accounting and Cost Principles Division, at (703) 767-3247.

/Signed/
Earl J. Newman
Assistant Director
Policy and Plans

DISTRIBUTION: C